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Monthly Letter

Business and Economic Conditions

General Business Conditions

New York, September 1961

THE business community is entering the fall season with confidence. Stepped-up buying is foreseen from all major sectors of the economy—consumers, business, and government. Record incomes have put consumers in more of a buying mood. Rising volumes of inquiries and shipments, together with improved sales prospects for the fall, have led businessmen to place orders with greater confidence and to plan increases in inventories and capital outlays. The $3.5 billion increase in defense appropriations, in reaction to the Berlin crisis, insures still greater government spending. If there is an auto strike, as was possible when this *Letter* went to press, business will be reduced, but the interruption obviously will be temporary, and will doubtless prove less important in the longer run than the inflationary effects if the settlement raises costs and prices.

In one sense, the recovery is an accomplished fact. Gross national product, personal income, industrial production, construction expenditures, and many other economic measures have recovered all their recession losses and are moving into new high ground. We have had the initial rebound, one of remarkable speed. What presumably lies ahead is a more temperate and sustainable rate of expansion and growth. The time for artificial stimulation of the economy is past. Nevertheless, the expansionary force of government spending programs pushed through to combat the recession will persist and swell the federal deficit. Although we still have considerable slack in the economy, at least as measured by unemployment, there are some apprehensions that government may have repeated the 1958-59 mistake of doing too much too late.

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New High in Production

This summer, business activity held up better than usual. Industrial production, as measured by the seasonally adjusted Federal Reserve index (1957=100), advanced to a new record at 112.4 in July. Capping the vigorous rise throughout the spring, the index pushed past the pre-recession peak of 111 set in January 1960.

The 10 per cent rise from recession low to new high in only five months, February-July, set a postwar record for speed of recovery. In 1958 it took 10 months after production hit bottom to match the pre-recession record, and in 1954 it took 13 months. In 1949, when steel and coal strikes interrupted recovery, a new peak was not reached until 9 months after the trough.

In each of the postwar expansions, industrial production continued to rise strongly for several months after previous highs had been matched. Beyond this stage, there tended to be a period of slower growth or a plateau, often lasting a year or two, before the next cyclical peak. The further marked rise in industrial activity generally anticipated for the months ahead would be in line with historical patterns. Prospects for an extended advance are encouraged by the way

the recovery has broadened. The initial upsurge was focused in steel. In more recent months, as steel output leveled out, other lines have moved up in a "rolling recovery."

Rising Flow of New Orders

The better flow of new orders being received by manufacturers, particularly those in durable goods lines, is one of the best omens of a good fall season. The Department of Commerce reports that new orders for durable goods, seasonally adjusted, rose 2 per cent during July to $15.2 billion, the highest since the buying rush just before the 1959 steel strike. Although defense contracts were an important part of the July rise, it was still too early to reflect the recently authorized expansion in defense spending. The main stimulus of added demand from this source will be felt by specific industries, including ordnance, aircraft, and textiles.

With shipments of manufactured goods on the rise, businessmen are seeing a need to alter inventory policies. Department of Commerce experts anticipate a rise in shipments of 4 per cent in the third quarter over the second, accompanied by a $1 billion increase in inventories —a reversal of the year-long downdrift. Since these estimates were based on a survey of leading manufacturers taken in May, the subsequent announcement of a defense build-up and the momentum of business expansion have no doubt brought upward revisions in plans. As inventory building adds to new order flow, and increasing orders and shipments point to the need for more inventories, the expansion is self-sustaining.

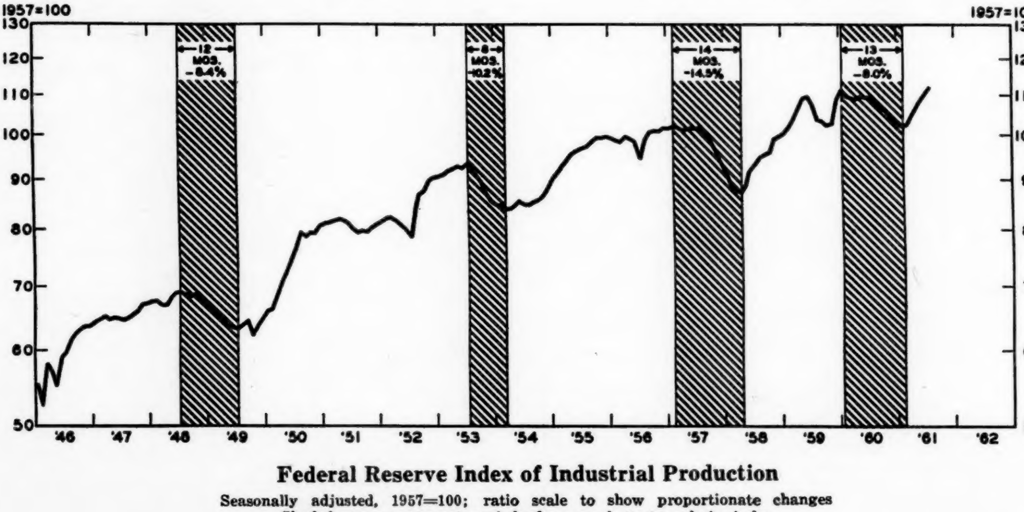
The record volume of industrial production in July, 1 per cent above the previous peak in January 1960, was turned out by approximately half a million fewer workers. Since the average work week in July was slightly shorter than in January 1960, the difference reflects savings of manpower from new capital investments and improvements in efficiency introduced during the recession. These factors also help explain why unemployment persisted through August at a rate just under 7 per cent, despite the upswing in most measures of output and income.

Consumers Able and Willing to Buy

With personal incomes moving up into the range of $415 billion this year, consumers have more money to spend than ever before. According to recent surveys, they are more confident than earlier this year and are enlarging plans for major purchases. Extensions of instalment credit have resumed their rise. Retailers are looking forward to a good fall season as evidenced by reports from resident buying offices.

Through midsummer the performance of retail sales was somewhat disappointing with aggregate figures still running a shade below 1960. Sales of auto dealers have consistently fallen behind 1960, but other merchants generally have equaled or modestly exceeded last year's results.

New car sales in August slipped somewhat further, but this was largely due to the imminence of new model introductions and shortages of some makes and body styles. Dealer stocks dropped below 700,000, lowest since the steel strike. Once new labor contracts are agreed to, the industry has high hopes that a favorable reception of new models will produce sales exceeding results for the closing months of 1960.



Federal Reserve Index of Industrial Production

Seasonally adjusted, 1957=100; ratio scale to show proportionate changes
Shaded areas represent periods from peak to trough in index

Fiscal Policy for the Cold War

The Berlin crisis and the steps President Kennedy has taken to meet it have turned the country's attention to ways of strengthening our national defenses. The great problem is to maintain a strong military defense without opening the gates to inflation and also without crippling initiative and enterprise by raising income taxes still higher. In all-out war people will work to defend themselves regardless of financial incentives. But in present circumstances we already have some visible weakening of zeal for work from excessive taxation and too many offers of "federal funds for free." We must never forget that military and economic strength reciprocally depend on the morale of the citizen and soldier. We must never forget that productive achievement comes only from human effort, usefully directed.

The President has expressed the hope that the added military spending so far projected can be carried out without producing inflationary strains or requiring higher taxes. That there remains slack in the economy—despite the achievement of a record rate of industrial production—is evidenced in unemployed labor and plant capacities. The thought is that, with this slack, we can absorb the impact of the $5 billion-plus budget deficit projected for fiscal 1962 without creating undue pressure on prices. The President did say, in his July 25 address to the nation, that increased taxes will be requested should they be needed to achieve a balanced budget in fiscal '63. But the Administration is so far holding to the expectation that the budget for the fiscal year beginning next July can be balanced out of the growth of revenues flowing from the vigorous recovery.

Perhaps it needs to be recorded that many observers are inclined to be skeptical about the prospects for holding the fiscal '62 deficit near $5 billion and for realizing an "automatic" balance in the fiscal '63 budget. The prime reasons for these doubts are the renewed upsurge in nondefense spending plus apprehension that military outlays will tend to swell further. Budget Director David Bell stated on August 21: "It may well be that defense expenditures are going to have to rise even more than they have already."

A Serious Omission

Many people who supported the President's purpose were disappointed that he did not mention in his speech the manifest need for pruning nondefense outlays to make room for higher defense costs. He did offer assurances that "costs in military procurement will be closely scrutinized" Nonmilitary outlays need even closer scrutiny at this juncture. This seems to be the view of the general public. According to a *New York Times* article on August 5, the President received some 20,000 letters and telegrams in response to the appeal in his July 25 speech for suggestions. By far the biggest group, the *Times* reported, urged cuts in government spending.

The *New York Daily News*, on questioning the man in the street, got the same response. As one man put it: "Additional taxes would not be necessary if various groups which get subsidies from the government would accept a percentage cut, as they should in times of emergency. Then mobilization could be financed within the budget."

In asking sacrifices from the people, it is for the government to set the example. Civil expenditures are the first ones to prune in a real emergency. Nondefense spending is one area where the United States has suffered no lack of growth: it has been rising by 6 per cent a year over the past decade. The amounts of money involved have reached such size as to make nonmilitary outlays the obvious point of attack. Simply holding back the launching of vast new programs for federal aid to education, housing, health insurance—all highly controversial in any case—would make room for needed military expenditures. If we are unable to defend ourselves, there will be no "welfare" left for anyone.

Senator Prescott Bush of Connecticut did some plain speaking in a Senate speech:

> . . . it is a time for Congress to exercise fiscal prudence. A prudent man does not prepare for uncertain and dangerous times ahead by loading himself down with new burdens and commitments, but rather readies himself for action by tightening his belt and getting rid of excess fat and excess baggage. . . .
>
> I say it is time that the President live up to his words and provide leadership, in cooperation with the Congress, and establish a system of rigid priorities in spending, eliminate waste in the executive establishment wherever it may be found, and defer nonessential programs, however desirable they may be until we can afford them without deficit financing.

Taxation and Defense

Raising taxes is commonly regarded as an alternative to cutting back nondefense spending. Public opinion surveys have indicated that people would accept higher taxes if they seemed essential to national security. Minds turn, instinctively and without sober thought, to the already overworked device of raising income taxes. But if we are really serious about asking people to "tighten their belts," the obvious and direct way is by taxes on consumption. We need

to recognize that we already have income tax rates at war-emergency levels and have kept them there for such a long time that they have become a real drag on the American economy. We find ourselves in a box because, unlike most other countries, we have not given proper attention to reductions and reforms in rates designed to bolster incentives to work and production, spur economic growth, and hence raise our capacity to accept and sustain higher effective tax burdens.

Thus we have the dilemma. The need for fiscal prudence is imperative, particularly in this day when so many people at home and abroad are ready to question the soundness of the dollar. Yet we cannot buttress our productive power by increasing discouragements to additional effort.

Although the Congress and people have not faced up to this critical issue, there are men in high places who see it. In his July 19 press conference, President Kennedy observed that our tax structure is "so strong" that it "contributed to strangling the recovery after the '58 recession." The chairman of his Council of Economic Advisers, Dr. Walter W. Heller, has offered the generalization that our progressive tax structure takes such a big bite out of rising income that it defeats the "achievement and maintenance of full employment." Dr. Arthur F. Burns, who was chairman of President Eisenhower's Council of Economic Advisers, has continually urged the need for reduction in personal income tax rates to increase incentives to constructive activities and to reduce the waste of energy on tax avoidance schemes.

The leading tax expert in the Congress, Wilbur D. Mills, chairman of the House Ways and Means Committee, has even questioned whether higher income tax rates will really bring in more revenue:

> On our present base for federal income taxes, I doubt very seriously that by adjusting rates upward over the course of a year or two, you would find that you are getting as much money under those higher rates as you are getting under existing rates.
>
> There are some things that can be done to get more money, but you cannot do it, in my opinion, by increasing the rate structure on the basis of the present base applicable to those rates.

Need for Broader Tax Base

The fact is that the one avenue of taxation still available for emergency use is a general sales or excise tax. The United States is about the only central government in the world that has not turned to general sales, excise, or turnover taxation as a major source of revenue. As the table shows, the U.S. Government raises only

Sources of Total Tax Revenues of Central Governments in 1960*

	Taxes on Income and Capital†	Sales, Excise and other Taxes
United States	86%	14%
New Zealand	64	36
Canada	60	40
Australia	59	41
South Africa	56	44
Netherlands	54	46
United Kingdom	54	46
Sweden	53	47
Japan	51	49
Denmark	41	59
Belgium	39	61
Spain‡	39	61
Mexico	37	63
Brazil	34	66
France	31	69
Switzerland	31	69
Turkey	29	71
Norway	28	72
Italy	26	74
W. Germany	22	78
Soviet Union	15	85

* Fiscal years ending in 1960. † Income and profits taxes, death duties, and estate and gift taxes. ‡ 1958.

Source: Derived from data in United Nations *Statistical Yearbook 1960.*

14 per cent of its revenues from special excise taxes (mainly those on liquor and tobacco), customs duties, and the like.

In contrast, the Soviet Union takes no less than 85 per cent of its revenues from turnover taxation. Denmark, Sweden, and Norway—with strong socialist parties—get one half to three quarters of their tax revenues from sales and excise taxes and customs duties. Germany uses transaction taxes to secure 78 per cent of its tax revenues. Other nations may appropriate as much of their national products for government use as we do. But we stand unique in the degree to which our Federal Government concentrates taxation on employment and production.

Twenty-nine years ago, when the Great Depression was sinking into the catastrophic classification, the Congress made a fateful decision to raise taxes to replenish falling revenues and to attempt this by scaling personal income tax rates up beyond 50 per cent—as had been done during World War I—rather than by a low-rate general sales tax. Most economists today would disapprove any addition to the burdens upon people when unemployment and business failures are widespread. But the decision against generalized use of sales taxation by the Federal Government has been held right through World War II and up to the present moment. Back in 1932, when the income tax touched only 1½ million people, the Congress feared the political repercussions of imposing a new tax that would be felt by all the voters. Things have changed a great deal in the meantime. Incomes and levels of living for the average American

are much higher; federal spending has multiplied twentyfold and the number of persons subject to income tax nearly fortyfold. At the same time social security taxes have created additional burdens for working people to carry.

Professor John F. Due of the University of Illinois, in his authoritative book on *Sales Taxation*, reviews the merits of such taxes. The extremely broad base allows the attainment of a very substantial yield, even at relatively low rates. He points out, moreover, "the superiority of the expenditure basis of taxation to the income basis, from the standpoint of incentive effects, economic growth, and inflation control," as well as its superiority from an administrative standpoint since it is collected from a relatively small number of business firms and sales figures are easier to ascertain and less subject to interpretative questions. If the aim is to hold back private demands for goods and services to make room for enlarged government demands, the direct way to do it is with a sales tax which avoids undesirable impacts on incentives, savings, and investments.

We are reaching a point of decision between curbing the climb of federal expenditures or adopting a broad-base low-rate federal sales tax. Those who want to postpone the day when this sort of tax will have to be introduced, and who also want a stronger defense and speedier economic growth, should see the need for a new sense of caution in authorizing and enlarging nondefense programs.

Reforming Taxes

Washington news dispatches report that efforts have been abandoned to push through the President's tax program, at least during the current session of Congress. The hearings held by the House Ways and Means Committee disclosed widespread opposition. Before deciding to lay aside any major tax legislation this year, the Ways and Means Committee had substantially modified or rejected almost every one of the President's proposals. The suggested abolition of the dividends credit and exclusion was voted down, as was the proposal to tax the earnings retained abroad by foreign subsidiaries of U.S. firms operating in economically "developed" countries. The involved scheme for credits against tax for business capital investments was simplified. The plan for dividend and interest withholding was modified by reducing the proposed withholding rate from 20 to 16⅔ per cent and by allowing for exemption of people not expecting to have tax liability. This last, while relieving inequities, would have brought on new administrative headaches.

The Committee hearings did bring out two things. One was that the original proposals had not been thoroughly tested from administrative and broad policy viewpoints; they would only have added to the overcomplexities of the tax system as it stands. The other point was that the business community was less interested in new "gadgets" than in the much-studied and consistently postponed question of income tax rate reforms. One witness after another pointed to rate reforms as the crux of the tax problem, often referring to the Herlong-Baker bill as a model of the proper approach.

What we need is a fresh, candid look at the jungle we call a tax system, something that evolved out of emergency expedients without contemplation of the effects on the fundamental equities and incentives we must have to survive as a leading example of what free people can accomplish.

The task is not to reduce government revenues. It is to reform excessive rates that divert energies from work to saving on taxes. Uncle Sam is in the position of a man whose business is hindered because he charges too much but who is unwilling to reduce his charges and trust to an elastic response.

This is the general concept of the Herlong-Baker bill, an approach which is gaining widespread support in the business community. In testifying on the President's program, Frank M. Cruger, president of the National Small Business Men's Association, emphasized that:

> The problem is the tax rates, and the solution is reform of the rates. The reform must be thoroughgoing. It must make a frontal assault on all the capital-robbing elements of the present system of tax rates and methods.

Concern about tax rates is not confined to businessmen. According to the most recent Gallup poll on the subject, reported in the *New York Herald Tribune* on July 9, a cross section of the nation's adults feel that income taxes and rates should be only about half their present levels. The following table shows, for selected total income levels, the amount of taxes the public would have assessed "a typical family of four—a husband, wife and two children," compared with what the 1961 personal income tax rate structure calls for.

Income Tax For A Family of Four
Suggested vs. Calculated Actual*

Total Income	If Public Set Tax Rates	As Calculated from Actual 1961 Rates
$ 3,000	$ 46	$ 65
5,000	216	420
10,000	706	1,372
50,000	7,250	18,294
100,000	25,000	51,192

*Reproduced from the *New York Herald Tribune* of July 9, 1961.

The Herlong-Baker Bill

Business groups, with eyes on the focal problem of rates rather than new gadgets, are giving their support to the bold and imaginative approach of the bipartisan Herlong-Baker bill. Leslie K. Pollard, speaking for the Wisconsin Manufacturers Association, told the Ways and Means Committee:

> This is the composite approach to tax action, as compared to the splinter approach which unfortunately has characterized so much thinking. Its great emphasis is on reform of steeply graduated personal tax rate structure, but it also would reduce the corporate rates, institute fundamental reform of depreciation, reduce rates on estates and gifts, and stop the confiscation of capital when funds are transferred from one long-term investment to another.

The Herlong-Baker bill would launch a program of scheduled reductions in both individual and corporate income tax rates every year for five years. The 52 per cent corporate rate would be cut one point a year to 47 per cent, with the normal tax rate declining from 30 to 27 per cent and the surtax rate decreasing from 22 to 20 per cent. This is not as much of a reduction as many businessmen might wish. It would still leave the regular corporate rate on undistributed profits higher than U.S. corporations ever had to pay prior to the Korean War. But at least it would give the shareholder, rather than the U.S. Treasury, the major stake in profits.

Personal income tax rates would be pared all along the line. The following table shows, for single individuals in selected taxable income brackets, current tax rates and the schedule of new rates proposed under the Herlong-Baker bill.

Current and Proposed Individual Income Tax Rates

Taxable Income ($ Thous.)	Present Rate	Rates under Herlong-Baker Proposal				
		1st yr.	2nd yr.	3rd yr.	4th yr.	5th yr.
0-2	20%	19%	18%	17%	16%	15%
4-6	26	24.5	23	21.5	20	17
8-10	34	31	28	25	22	19
16-18	50	45	40	35	29	23
26-32	62	55	48	41	34	27
50-60	75	66	57	48	39	31
90-100	87	76	66	56	46	38
Over 200	91	82	72	62	52	47

The rate applicable to the first $2,000 of an individual's taxable income would be reduced successively from the present 20 per cent to 15 per cent at the end of five years. The large number of middle-income people with taxable incomes in the $8,000 to $10,000 bracket would have their top rate reduced from 34 per cent to 19 per cent when the program had reached its goal. The rate on taxable incomes in the $16,000 to $18,000 range, now 50 per cent, would be cut to 45 per cent in the first year and eventually to 23 per cent. The 91 per cent top personal income tax rate, highest in the world, would be lowered to 82 per cent the first year and to 47 per cent in five years, making it the same as the proposed corporate tax rate.

As the table indicates, the rates proposed by the Herlong-Baker bill rise progressively from a 15 per cent initial rate, but much more slowly than under the present steeply graduated rate schedule. Moderating the rate progression is the major goal of the program's sponsors:

> The emphasis we place on compression of the graduated scale of individual tax rates reflects the fact that graduation is the worst saboteur of the economics of progress. While the most senseless and uneconomic rates are in the highest brackets, the steepest climb in graduation is through the middle and not the higher brackets. . . .

The scheduled reductions of income tax rates would be made only when the federal budget was expected to show a surplus. The bill provides built-in postponement procedures which would permit the President and Congress to spread out the five-year program of tax cuts over a nine-year span if necessary. It would also, in its present form, embrace a number of ancillary changes to lighten the load of taxes on capital. Depreciation allowances would be reformed and simplified, estate and gift taxes reduced, and taxation of capital gains modified.

The purpose is not to give anything away but to return to the citizen a better inducement to work to develop taxable income with benefits alike to production and federal revenues.

Can We Afford Rate Reform?

The question naturally arises whether we can afford fundamental income tax rate reform. Congressmen Herlong and Baker calculate costs of the five-point cut in the corporate rate at $2 billion over the entire five-year period, individual rate cuts at about $11 billion, and the depreciation, estate and gift tax, and capital gains tax provisions at another $4 billion.

This is a formidable $17 billion total. But it would be spread out over five years or more and would represent no real loss of revenues at all if the plan succeeded—as income tax reforms in other countries have succeeded—in developing a more rapid rate of growth in the economy and in the tax base.

"The intent of the legislation," in the words of its sponsors, "is to give priority for use of the revenue gain to tax rate reform over any and all spending on new or old programs except that necessary for national security." It would be hard to conceive of any legislation that could so

lift the spirit of American enterprise in a sustained way.

The Herlong-Baker program aims at stimulating the economy by a two-pronged approach. On the one hand, it would increase the supply of capital available for investment, the engine which drives the economy to higher levels. As its sponsors say:

> It is long past the time when we should have recognized that we need more capital for more growth just as does the rest of the world. We cannot afford a tax structure which converts job-creating growth capital into current government spending. Until federal tax rates are reasonable and moderate, further increase in federal spending will be at the expense of greater growth in the private economy.

On the other hand, reductions in tax rates would reduce the slice taken by the tax collector out of the rewards for superior work effort and risk-taking investment. People would have more incentive to develop income and invest in worthy, job-creating enterprises. Small business particularly would benefit if the successful individual—once a prolific source of risk capital—were again permitted to build a pool of investable funds out of income. The whole economy would be regenerated if ambitious and industrious people had more incentive to raise themselves on the economic ladder. We are frustrating what is perhaps the American genius—the talent for turning big dreams into realities.

To some who approve the general objective of tax rate reform, it may not seem realistic to set up a rigid structure of reductions five years in advance. There is no denying that in the uncertain world in which we live, "the best-laid schemes o' mice and men gang aft a-gley." But rough seas do not make setting a course unnecessary, they merely make it more difficult. Whether or not it would prove feasible to hold to the exact program set out in the Herlong-Baker bill remains for the future to show. There should be little dispute, however, about two key aspects. First, tax reform should have a higher priority on the Congressional agenda than it has had up to now. Second, we have practical budgetary needs for a gradual reform, year after year. In short, we need a plan and policy of keeping tax reform continuously on the agenda for progress.

Taxes and Growth

Actually the real question is not whether we can afford tax reform but whether we can afford to postpone it any longer. We have been fortunate in the willingness of our people to bear heavy tax burdens. But the voluntary system of tax reporting and payment on which we rely can work only so long as the citizen believes that it is basically fair and equitable. Yet, increasingly, thoughtful people are coming to share the view, expressed crisply in *The Saturday Evening Post* for July 15:

> . . . anyone who believes that the income-tax laws as they now are applied are simple, logical, or equally fair to all, is naive to the point of idiocy. The world's most efficient taxing system is actually a fantastic tangle of inequities and special preferences, and every year disenchanted taxpayers in greater numbers are becoming aware that this is so. By any standard which may be applied in determining what makes a tax system good or bad—its fairness, its effect on the economy, the adequacy of the revenue it provides, its ease of administration and compliance—our present taxing process is full of structural faults.

Closing the so-called tax loopholes might seem to be one answer to the problem. But this ignores the fact that the reliefs were sought and granted by Congress as essential escapes from over-repressive tax rates. Close them down tight and we risk suffocating the economy.

Even spokesmen for organized labor groups, while placing major stress on closing "tax loopholes," have swung over to recognition that the progression of personal income taxes is over-rapid. Pointing out that "it is clear that these high rates have been a major factor working to open new loopholes and to widen existing ones," Peter Henle, assistant director of research for the AFL-CIO, told the Ways and Means Committee in 1959 that: "It would therefore be sensible and realistic to consider reductions in the upper income tax rates." Professor Stanley Surrey, another foe of "loopholes" and now Assistant Secretary of the Treasury in charge of tax matters, suggested at the same hearings "a reduction in the top rates of tax to 70 per cent or 65 per cent."

A Silly Business

With the economy forced to gasp for breath through "loopholes," it is no wonder that so many people find our rate of economic growth inadequate. Proposals to spur growth by government spending simply evade the fundamental issue. Big spending programs would require or threaten even higher taxes, compounding the basic problem and raising the question of whether the economy can maintain its growth rate, not to mention increase it. It is a little silly, as Elliott V. Bell, editor of *Business Week*, has said, to "put ourselves in the ridiculous position of spending simply to get back into circulation money that an unduly severe tax system has taken away from consumers and investors."

It is high time we realized that the biggest single obstacle to growth is an over-repressive tax system. Abroad, tax reliefs have become a principal means of re-energizing some of the fastest-growing nations in the world. Most spectacular, perhaps, is the rise of Germany from a position of near collapse after World War II to a major place in the world economy. Back in 1950, Germany acted against the wishes of American advisers and decided instead to bring down tax rates and rely on this to stimulate the energies of its people toward the creation of more goods and wealth. What resulted is commonly called the German "miracle."

The top German personal income tax rate is now 53 per cent. With our rates running up to 91 per cent, how much more reason do we need to get our rates down. Our income tax long ago ceased to be a burden solely for the "rich." Income levies are generally frustrating the aspirations of millions of people to enjoy the satisfaction of accumulating pools of capital under their own control.

As incomes rise over the years, the average man is going to be pushed into tax brackets which he never dreamed would apply to him. Mere continuation of the 1950-60 rate of growth in average income, for example, would put the average family head in the 34 per cent tax bracket within 25 years. A successful, unattached individual, without the relief of income splitting or extra exemptions, would, of course, pay even higher rates.

Amid all the talk of government action to spur growth, we would do well to bear in mind that the American living standards which have set an example to the world were not created by government. The well-being of a nation stems from the energy and efforts of its people working to create better lives for themselves and their children. Recognition of this time-tested truth was the key to our success in the past. It can serve us equally well in the years ahead. What we need is the adoption of tax reforms to create an atmosphere of forward-looking optimism. Growth of effort and capital will take care of the growth of the economy.

The Problem of Rising Prices

The United Kingdom this summer faced its sixth postwar economic crisis. As in the previous emergencies, the problem centered in an upcreep of prices, a weakening balance of foreign trade, and a drain on official gold reserves. To weather the storm, the British Government in late July took a series of calculated moves: it raised bank rate from 5 to 7 per cent, increased consumer taxes, cut back overseas spending, and trimmed domestic government outlays. It also called for a "pause" in increases of wages and dividends, and froze wages of government workers. It arranged a $1.5 billion drawing from the International Monetary Fund and a $500 million stand-by credit. These measures eased the immediate pressure on sterling. But, as the Government emphasized, the ultimate solution can only be found in restoring the discipline and competitive strength of the economy.

The British actions provided dramatic evidence that concern about inflation, stilled for several years, is again on the rise, and not only in Britain. In most Western European countries, pressures from labor shortage and wage increases are bringing an upthrust of prices. In the United States, the mounting of government expenditures to new postwar peaks has awakened apprehensions that another bout of inflation troubles may lie ahead.

In view of these developments, special interest attaches to the authoritative report on *The Problem of Rising Prices*, published last May by the Organization for European Economic Cooperation (now the Organization for Economic Cooperation and Development, of which the United States is a full member). The product of two years of study by an international group of six leading economists*, the report could not be more timely. The London *Times* noted that it obviously had influenced the British Government in its recent measures to contain inflation and defend the pound. The *Economist* commented that it "should be compulsory reading for all politicians."

The study of the six experts goes over much of the same ground covered by such studies as "Employment, Growth, and Price Levels" by the Congressional Joint Economic Committee in 1960 and the report of the Commission on Money and Credit earlier this year. But what makes the OEEC study unique is that it is based on the experiences of the twenty member countries (including the United States and Canada as associate members) in the period 1953-60. The findings are particularly valuable because the international experts were free to take a detached view of the issues and managed to achieve a remarkable degree of agreement in diagnosing the basic problems.

* The six economists were William Fellner of Yale University; Milton Gilbert, now economic adviser to the Bank for International Settlements; Bent Hansen, director of the National Institute of Economic Research in Stockholm; Richard Kahn of Cambridge University; Friedrich Lutz of Zurich University; and Pieter de Wolff, director of the Central Plan Bureau at The Hague.

The Diagnosis

The OEEC economists point out that effective policies to prevent inflation require an understanding of the causes. From their review of developments in the twenty countries, they identified four independent—though interrelated—factors behind rising prices. These were:

Special or temporary factors (such as bad harvests, increased sales or excise taxes, and relaxation of rent controls).

Excess demand for goods and labor.

Excessive negotiated wage increases.

Monopolistic pricing.

The "special" factors which make up the first group were regarded as of minor importance. They pushed up consumer prices, but were not really "inflation," even though they affected price indexes. For this reason, the report warns against "making a fetish" of the cost-of-living index and against linking money incomes to existing price indexes.

Of the others, two were judged of "predominant importance"—the pull of excess demand and the push of excessive wage increases: "We believe that the most difficult task for stabilization policy is to recognize and treat these two causes of inflation as independent forces."

The report observes that demand inflation, symptomized by shortages of capacity, materials, or labor, was extreme only in Turkey, Spain, and Iceland during 1953-59 and in France in 1956-58. In other cases where it was found to be a factor, demand inflation was regarded as relatively mild and as having been present for only relatively short periods—usually two years. The United States is said to have experienced excess demand only from late 1955 to early 1957. Italy avoided it almost entirely while experiencing remarkable economic growth.

The experts cited wage-push as the more persistent type of inflation. That is to say, organized labor more or less regularly pushed wages well above levels that would have resulted from supply and demand forces alone and beyond increases in labor productivity. The conclusion that "excessive wage increases constituted both an important and independent inflationary force" in many countries is shared by all six members of the study group. They point out that "wages increased at a substantial rate" during nearly all of the 1953-60 period, "including periods when there was no real shortage of labor" and even, in certain industries, where "there was substantial unemployment." The report explains this by citing the "tendency for the key bargain to be set in the industry where demand is most active and the rise in productivity . . . is highest." Workers in other industries try to match these gains, thus creating a "wage-wage" spiral.

Wage-push inflation was found to be particularly pronounced in the United States, the United Kingdom, the Netherlands, and the three Scandinavian countries. On the other hand, it was not an important price-raising factor in Germany, Austria, Italy, and Switzerland. Referring specifically to the United States, the report says: "The situation has been quite unsatisfactory and, with demand pressure less intense than in Europe, round after round of wage increases have weakened the competitive position of American industry in world markets."

In contrast with some recent American studies of the inflation problem, the OEEC experts give far less importance to monopolistic pricing or "administered prices" by business as a cause. The majority report on the Joint Economic Committee's study of "Employment, Growth, and Price Levels" put more stress on the use of market power by business as a price-raising factor than on union power, while the Commission on Money and Credit seemed to give equal importance to both kinds of market power. The six OEEC experts, on the other hand, did not find business pricing policies to be a serious inflationary problem:

> . . . the danger of aggressive pricing to raise profit margins is a limited one. It can add fuel to the fire in an inflationary situation. But it is not likely to be the starting cause, nor can it be a cause of continuously rising prices. In this respect, an increase in profit margins differs from an increase in wages; there can be a wage-price spiral but there cannot be a profit-price spiral, for the simple reason that the dampening effect of higher prices on output and sales would be immediate when consumers' incomes were not rising. Moreover, a deliberate raising of profit margins is necessarily limited at any time to a few industries—there is no "profits round."

The idea that rising prices in the United States stem from arbitrary price increases designed to fatten profits is denied by the fact that competition is too keen to permit it. This is apparent in the record of profits, which have not been keeping up with the growth of the gross national product. Profit margins have been tending to narrow for a decade.

Wanted: A New Therapy

It is idle to think, the report emphasizes, that the problem of rising prices will solve itself: "Some things will have to be done differently in the future if the performance of the past is to be improved upon."

Nevertheless, the OEEC experts are optimistic about the chances of checking inflation of the demand-pull variety. They note that

even in extreme cases of excess demand, governments that were forced by balance-of-payments difficulties to take action were able "to find a program of monetary and fiscal measures that did the job in a relatively short time." The real difficulty was in deciding when to take action and what measures to take. Failure was usually a case of "too little and too late."

What is needed, the experts assert, is not more "massive measures" but more flexible adaptation of stabilization policy to the changing economic situation: "Stabilization cannot be attained by a series of jerks to the economy." A key recommendation in this regard is more flexible use of fiscal policy—to supplement, not replace, monetary measures which would continue to play a major role.

In making fiscal policy more flexible, the experts believe that taxes can be adjusted more readily than expenditures. They suggest that legislatures give advance authorization to the executive branch of government to raise or cut taxes over a prescribed range, the aim being to influence private spending "with the facility that now attaches to changes in, say, the discount rate." The British Government did this on July 25 when it raised consumer taxes by 10 per cent under powers granted by Parliament a week earlier. In the United States, a similar delegation of power enabling the President to change the first-bracket rate of the personal income tax has been suggested in a variety of quarters, including the Commission on Money and Credit. But in this country, a thorny constitutional question arises, since powers to tax are exclusively reserved to the legislature and the executive does not hold office at the will of the legislature.

Dealing with the Wage Push

The only place in the report where disagreement appeared among the experts was on the controversial question of how to deal with wage-push inflation. And this is not surprising since most suggested solutions tread upon freedoms of the labor market—freedoms of employers to pay what the market demands to get good help, and freedoms of working men, and organized groups of working men, to make whatever demands they like. In other words, solutions tend to run toward *dirigisme*.

Four of the experts took the point of view that government should have a definite policy on wages "just as they must have monetary and fiscal policies for dealing with the problem of demand." The French followed this prescription in restabilizing the franc back in 1958-59, imposing a freeze on wages and salaries in government and nationalized industries and (with some exceptions) banning escalator clauses. The recent British measures, as noted earlier, included a freeze on government pay of six months or more and a request for a corresponding "pause" in wage increases in private industry.

Specifically, the four experts suggest that the government (the stabilization authorities) should calculate the amount of wage increases that would be "appropriate to the economic situation and consistent with stability of the price level." This "norm" would depend primarily on experience and expectations regarding the longer-run rate of productivity increase in the economy. The idea is that the government would make this "norm" known and mobilize support for its acceptance throughout the country.

The other two members, Professor Fellner of Yale and Professor Lutz of Zurich, agreed that governments should educate the public about wage-push inflation. But they expressed little faith in the effectiveness of wage "norms" as such. They fear that to make them effective would require "extensive regulations relating to individual wages and prices," and these in turn would be significantly influenced by "political considerations" and "group pressures." This would simply shift labor-management wage disputes from the bargaining table to the political arena, where the line of least resistance is to give everyone what he wants.

Thus, Professors Fellner and Lutz feel that "stabilization authorities" could not have "the knowledge and independence of group pressures" needed properly to appraise market forces and develop a wage structure appropriate to our vast, complex economy. Government might thus load the economy with inflation and fairly high unemployment at one and the same time. They believe that, given the right monetary and fiscal policies, there is no need for detailed regulation of wages. If there is need for a change, they say, it should be in the direction of modifying the "size and the functions" of groups on both sides of the bargaining table.

Lessons for the United States

The report underscores some basic ideas that are particularly important if this country is to come to grips with the modern inflation problem. First, the six experts stress their belief that "stability of the level of prices should be one of the basic objectives of economic policy." Moreover, they affirm that it is a feasible goal. The difficulties in achieving it are not so much technical, but "fundamentally political—in the broad meaning of that word." What is needed is a political decision, based on broad public understanding and support, to bring inflation under control.

Public understanding of the matter has been lacking, partly because American studies of the inflation problem have tended to gloss over the serious effects of spiraling wages here. It has even been argued that inflation is the price we must pay for economic growth. But the OEEC report sees excessive wage increases as being at the heart of our difficulties:

> Perhaps more than in most countries, inflation in the United States has been an obstacle to economic growth; we believe that moderation in the rate of the wage increase is fundamental to avoiding such inflation in the future.

This realistic view is finding support in influential quarters. In a talk before the Advertising Council on June 5, Treasury Secretary Douglas Dillon was quoted by the *New York Herald Tribune* as saying that the OEEC experts had put their finger right on this as a problem in the United States: "The greatest threat to our dollar inflation-wise comes from this wage-price cost-push inflation."

A voluntary scheme of wage restraint was advanced a fortnight ago by Professor Henry C. Wallich of Yale, a former member of President Eisenhower's Council of Economic Advisers, in testimony before the Joint Economic Committee. He had outlined his views earlier in a letter to the *New York Times* on April 18, 1961:

> At the present time wages are advancing at an average rate of 3 to 3½ per cent annually. Productivity gains over many years have averaged about 2 per cent. Continuation of this gap between wages and productivity threatens a continued creeping up of prices at a rate of 1 to 1½ per cent. In periods of high business activity the increase may be faster. . . .
>
> If we want a stable price level and a strong balance of payments we shall have to accept the average productivity gain of approximately 2 per cent a year as the standard for noninflationary wage increases. This standard should, of course, be a voluntary one, based upon a national consensus and implemented by persuasion. . . .
>
> Under a 2 per cent standard, labor will be no worse off than it has been under our present witless procedures. Instead of forcing 3 to 3½ per cent increases, part of which is canceled by a 1 to 1½ per cent price increase, labor would have the same approximately 2 per cent fully validated by a stable price level.

It is hard to know how far a government can venture on this path without getting into what Professors Fellner and Lutz called "extensive regulations relating to individual wages and prices." It is one thing to apply a freeze in a real emergency. It is quite another thing to try to set up "norms" that would deny opportunity for expanding industries to get more people and for waning industries to lag behind so the differentials could assist proper labor mobility.

Labor's Stake

In this country there has been a tendency to assume that creeping inflation is inevitable because of the desire of organized labor for periodic wage increases, regardless of productivity increases or the state of the economy. Walter Reuther, president of the United Auto Workers, testifying before Congress on behalf of the AFL-CIO last February, expressed the traditional trade union position that the government must strike off what he called "the legislative shackles that now hamper unions" but at the same time must use its powers to "raise the general level of wages."

Lately, however, labor is becoming aware that government intervention can hurt as well as help. Under the heading "Wage Restraint Not Required," the July *I.U.D. Bulletin,* published by the AFL-CIO's Industrial Union Department, laments that "some high up in the Administration are voicing the industry line that workers' wages are the basic cause of inflation and that the big need is to fight such inflation." It sees in this a revival of the "old anti-labor 'wage-price' spiral." Here is the real seat of the trouble: unwillingness of many leaders of organized labor openly to recognize the unchallengeable fact that the price of a product is necessarily related to the cost of producing it.

If we are to avoid some system of wage controls, voluntary or otherwise, labor leaders must show more restraint in their wage demands, based on a realistic understanding of the futility of wage-price leapfrogging. While we do not want to create new rigidities in our economy by freezing wages or setting up wage norms, neither do we want continuing erosion in the value of the dollar with its fatal consequences in terms of social equities and the prestige of the nation.

Working people, moreover, have a vital stake in price stability. Moderation in the rate of wage increases can lead to higher employment and faster economic growth by stimulating more capital investment and greater increases in productivity. And as the OEEC experts point out:

> As against these tangible and significant benefits to our working population and to the nation, there is nothing significant that excessive wage increases have to offer. Particular labor groups may gain a small differential over other workers for a time, though the evidence shows that this is not long lasting. It is our belief that any gains in real income which labor as a whole might make at the expense of profits, or vice-versa, are insignificant compared with the gains which can be realized by both parties through the maintenance of fuller average employment and more steady economic growth.